Cliff Notes Summary of the American Taxpayer Relief Act

Tom McGuigan

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The drama of the first half of the fiscal cliff – the portion dealing with taxes – is behind us as Congress and President Obama agreed on tax policy for 2013 and beyond. Obscured in the debate over whether income tax rates would increase for married couples with income of $250,000 versus $450,000 (and slightly lower amounts for singles), however, was the fact that taxes will rise for nearly all working Americans.

This increase is due to the reinstatement of the full payroll tax that covers Social Security and Medicare. Employers are required to withhold the increased amount from paychecks in 2013. A married couple, for example, each earning $50,000 in wages, will pay a total of $2,000 more this year over last.

Other tax rates for most Americans will remain the same as the law made permanent the rates on income, dividends, and capital gains that have been temporarily in place since the early 2000s. The particularly good news for investors in the lower income brackets is their capital gains and dividend income can escape taxation completely.

Consider a retired married couple with $20,000 from a pension, $40,000 from Social Security and $30,000 from long-term capital gains. According to the tax calculator from the Tax Foundation, the favorable treatment of the capital gain income drops their tax bill from $7,823 to $3,323.

Because the law increases the income tax rate only for married filers over $450,000 and singles over $400,000, many taxpayers below those thresholds mistakenly believe their taxes will not rise. However, the law increases taxes on couples earning over $300,000 and singles over $250,000 by taking away itemized deductions and personal exemptions. The amount of income subject to taxation increases even though their rate stays the same.

Further, the tax increases included in the Patient Protection and Affordable Care Act take effect in 2013. Married couples with income above $250,000 will pay an extra 3.8 percent on the lesser of either their investment income or the amount their income exceeds the threshold. The investment income includes interest, dividends, capital gains, distributions from non-qualified annuities, rental income, among other sources. In addition, wage earners will pay an extra Medicare tax of 0.9 percent on wages exceeding the threshold, which is $200,000 for single filers.

Those families with income above $450,000 for married couples and $400,000 for single filers will see their taxes rise substantially. They will be subject to a new bracket of 39.6 percent, their capital gains and dividend rates will rise to 20 percent, and they will be subject to the additional taxes from the Patient Protection and Affordable Care Act.

A two-income family with substantial itemized deductions, $30,000 in qualified dividends, $30,000 in long-term capital gains, and where each spouse earns $300,000 will pay total federal taxes of about $205,000 including payroll tax, which represents an increase of about $19,000 over 2012.

Taxes are one of the few certainties in life and most people understand their obligation to pay. At the same time, we have a duty to our clients to ensure they are aware of how to reduce their taxes to the lowest amount permitted by law. The new tax law provides a strong incentive to engage in effective tax planning.

Fortunately, the difference between tax rates on income versus capital gains and dividends, along with the availability of sophisticated strategies, provides us with significant opportunities to meet our duty to clients by managing their tax liability.

Tom McGuigan is a Certified Financial Planner™ professional Excencial Wealth Advisors, 187-B Boston Post Road, Old Lyme, CT 06371, (860) 434-5999. tmcguigan@exencialwealth.com